

Significance and Effect of Structural Reform of China's Petrochemical Industry

Lu Wei

**Development Research Center
State Council of P.R.C.**

November 1998

In 1998, an important step was taken in structural reform and strategic restructuring of enterprises of China's petrochemical industry. This time, structural reform starts from organization readjustment and separation of government administration from enterprise management, breaking down old petrochemical industry management system, which set barriers between up-streams and down-streams and integrated government administration with enterprise management, and organizing China Oil & Gas Group and China Petrochemical Group, which realize integration of upstream and downstream, internal and external trade and production and marketing. This important restructuring measure marks a new stage, in which, restructuring of China's state-owned enterprises is going forward from restructuring of individual enterprises to restructuring of the whole petrochemical industry of China. It also indicates that China's petrochemical enterprises will take an active part in international competition on world markets.

Significance and Effect of Structural Reform of Petrochemical Industry

There is important background for restructuring of China's petrochemical industry. Firstly, China's state-owned economy has entered a stage of strategic restructuring. Restructuring of state-owned enterprises has changed from invigorating individual enterprises to invigorating the whole state-owned economy. Through restructuring of state-owned enterprises, optimization of capital allocation and optimization of enterprise organization can be realized, so that state-owned capital can flow from ordinary non-strategic industries, or inefficient and inferior enterprises to strategic industries, or efficient and superior enterprises and be concentrated on the latter. Petrochemical industry has been a basic industry, which has been under mandatory planned management, and now faces deepened reform and assets restructuring. Secondly, the strong trend for integration of world economy poses a challenge to China's petrochemical industry. China's petrochemical industry has, for long, adopted a policy of industrial separation and monopolization. Although its total output is among the top in the world, no large-scale enterprises capable of competing with international strong companies have been formed due to decentralized repeated constructions of enterprises at lower levels. Facing fierce international competition, China's petrochemical enterprises must readjust their internal structures, strengthen competitive power on integral basis, and join international competition on world petrochemical markets.

It is a new starting point for the development of China's petrochemical industry to organize two giant petrochemical groups, which integrate the upstream and downstream production enterprises. With the organization of the two giant groups, a basic structure of China's petrochemical industry management system has been formed, which creates favorable conditions for further development of China's petrochemical industry and further strengthening international competitive capability of China's petrochemical enterprises. The significance of the

restructuring lies in :

1. This meets requirement of restructuring of state-owned enterprises and allows separation of government administration from enterprise management. The newly formed government suggests that most state-owned enterprises will be subjected to modernization restructuring of enterprise system, which will be completed within three years. The former China Oil and Natural Gas Corporation and China Petrochemical Corporation were national monopoly administrative corporation, which integrated government administration with enterprise management. China Petrochemical Bureau is responsible for the function of government administration while the two newly organized group corporations have become economic entities and legal persons, which use assets as a link between them and their member companies. This has created favorable conditions for promoting modernization of enterprise system and standardization of petrochemical enterprises.

2. Restructuring breaks down barriers among different industries and allows integration of upstream and downstream. In the past, barriers among different enterprises and different administration departments within the petrochemical industry were serious. Under the old administration and management systems, oil-extracting enterprises were not allowed to run oil-refining operation while oil-refining enterprises were not allowed to run oil-extracting operation, nor oil-producing enterprises allowed to market oil products. Link between upstream and downstream was cut artificially and optimized capital allocation blocked. As a result, production was separated from supply and marketing, consequently, enterprises separated from markets, and trade cost and enterprise operation risks increased, contradiction of benefits of different departments occurred, repeated construction of similar enterprises happened one after another, and scale efficiency could not be achieved. Organization of the two giant petrochemical groups allows breaking down barriers among different industries and industrial monopoly, and straightens out relations between upstream and downstream so that large enterprises can run product production and marketing at different levels within themselves and be directly engaged in petrochemical products import and export. This restructuring complies with international practice and helps China's petrochemical enterprises to connect them to international markets.

3. The restructuring meets requirement of fierce competition on markets and breaks down administrative monopoly in this industry, resulting in a setup of competition among several large companies. In the trend of integration of world economy, China's petrochemical enterprises are facing fierce international competition. Now the problem is not whether we want to be involved in international competition or not, but that international competition is evolving into domestic competition. Since 1993, China has become an oil products net importing country. By the year 2000, quantity of crude oil supply shortage in China would be 28 million tons. With sharpening of contradiction between oil supply and demand, China's domestic oil markets will be further opened to foreign companies. In that case, consumers will choose cheaper and better products. Since 1990, large quantity of foreign oil and oil products has flooded into China, resulting in heavy overstock of crude oil and refined oil products. If survival of China's petrochemical enterprises was based on protective monopoly, they would not be strong enough to challenge foreign competition when foreign oil products and investors flood into China's domestic markets. Therefore, the present monopoly in this industry in China has to be broken down so that competitive capability of China's petrochemical enterprises can be strengthened and get ready for wider

opening of China's domestic markets to foreign companies, and consequently to take par in international competition.

4. Restructuring of state-owned enterprises has changed the economy controlled by mandatory plan and realized primary transformation of price formation mechanism. In the past, mandatory prices were used in petrochemical industry. With restructuring of the industry, mandatory price system controlled by the state has been abolished, and control over enterprise transaction prices has been lifted while state controlled guiding prices are used as guideline for pricing in transactions. Enterprises hold right to decide transaction prices independently within the range of guiding prices determined by the state.

The above described restructuring will have effect on the following aspects. Firstly, It helps form nationwide unified big markets. With organization of the two large-scale petrochemical groups plus China National Offshore Oil Corporation, a setup of competition among several large companies in the whole country is formed. Each of the large petrochemical companies has its own business lines, on which it puts particular emphasis, and they also have business lines, which cross others', so that consumers can make selections among them, creating certain degree of competition. In the meantime, competition will promote nationwide market exploitation and product developing by large companies. In so doing, they will readjust and restructure their existing marketing channels according to market rules so that national petrochemical product markets will be further perfected and developed.

Secondly, it promotes further restructuring of enterprise assets. After organization of the two petrochemical groups, major task for next step is to reform the two groups in accordance with modern enterprise system. At present, only administrative assets allocation between the two groups has been completed. Further readjustment and integration between and inside the two groups are necessary. In future competition, for their survival and development, assets restructuring between and inside groups through merging and stripping off will be initiated to change the current situation of decentralized operation in order to achieve integrated superiority in competition and strengthen competition power.

Thirdly, enterprise restructuring can promote diversification of main investment channels. After separation of government administration from enterprise management, state-owned economy still plays predominant roll in oil and gas industry. However, oil and gas industry is a fund-concentrated industry, which has to rely, in addition to state-owned capital and investment from government, on public funds and foreign capital for its future development. Therefore, diversification of main investment channels is a developing trend in the future in petrochemical industry. After separation of government administration from enterprise management, administration departments will be responsible mainly for formulating policies and standardizing market order, and no longer have the function as owners and operation managers of state-owned enterprises while state-owned enterprises will be ordinary members in market competition. All this will provide basic conditions for equal competition among different investors.

I. Problems to be Further Solved in Structural Reform and

Restructuring of Enterprises of petrochemical Industry

The goal of structural reform and restructuring of enterprises of China's petrochemical industry is to organize, according to characteristics of the industry, several large companies, which are able to join in international competition. As China's oil industry has for long executed management system of

planned economy of mandatory nature, and since the 80s, has adopted industrial monopoly operation strategy with upstream separated from downstream, many aspects of management system and operation ideas in petrochemical industry are ill-adapted to market economy. Restructuring is a means but not purpose. In order to carry out the tasks of structural reform and restructuring of enterprises and achieve anticipated goal, it is necessary not only to make readjustment of organization but also to realize changes of ideas and system so as to be adapted to requirement of building socialist market economy and to international competition environment. From all this, we can see that China's petrochemical industry still faces more difficult and complex tasks of reform and restructuring. Problems to be solved from now on are as follows.

1. Competition mechanism should be introduced into the industry. Nationwide unified markets should be formed and regional monopoly prevented. The current petrochemical groups or corporations are organized basically on the basis of regional location. But that does not mean that these large groups or corporations will restrict their business activities within the regions, in which, they are organized and adopt regional monopoly. Competition promotes increasing of efficiency. Organizing large industrial groups according to regional locations allows straightening out relation of separation of upstream from downstream and laying necessary foundation for enterprises' entering markets and joining competition. Ultimately, enterprises seek their survival and development in competition. Therefore, competition mechanism should be introduced into the petrochemical industry and competition order set up to prevent regional monopoly of materials and resources after breaking down barriers between upstream and downstream and departmental monopoly.

2. Enterprise operation mechanism should be changed to realize intensive growth. Size of a large enterprise does not necessarily mean strong competitive capability. Production and sales income of the two newly organized groups are of large scale, but the level of their market operation management is rather low compared with that of their strong competitors in the world. China's inland oil and gas extracting industry exercises basically mandatory planned management, under which prices and circulation are controlled by state plan, general contract of production of the whole industry is carried out and oil fields organize their production according to production targets assigned to them. In that case, it is impossible for enterprises to compete with large international companies. From a long-term view, production-centered operation management method has to be transformed to market-oriented and benefit-centered commercialized business management.

Therefore, on one hand, the government should grant enterprises full authority for management, and on the other hand, enterprises must change their internal management methods, transform production-centered management to benefit-centered management, and administrative management to market operation strategy management. Enterprises should readjust their product mixes according to market demands and their own superiority, make full use of domestic and international resources and markets, intensify power for product development and extend processing depth. China's oil industry should not only introduce foreign up-to-date technologies and capital, but also march forward gradually to world markets to realize transnational operation.

3. The government should speed up formulation of systematic oil policies and exercise management in accordance with law. Oil is a very important primary

energy and important industrial raw material, which has great effect on international payments equilibrium. Oil, as an important politic-economic commodity, is given great emphasis by nearly all countries in the world. China is a large country with a huge population. Stable oil supply is one of the key factors in guaranteeing steady growth of China's national economy. Therefore, during transformation from planned economic system to market economic system, state administrative departments should formulate effective and proper oil and natural gas policies to guide and standardize behavior of enterprises, and create good environment for enterprises to take part in international competition. In the past, oil and natural gas resource management, oil exploration, extraction, processing and trading were separated in five different departments, non of which could consider structural reform and policies for development of oil industry from a view of the whole state. Therefore, explicit and systematic oil industry policies are in urgent need.

After realization of integration of upstream with downstream and commercialized business management, administrative departments of petrochemical industry should, from a view of big petrochemical industry, speed up formulation of oil resource developing and utilizing strategy, oil reserving policy, oil consuming policy, internal and external oil trading policy, foreign funds using policy, policy system and laws in oil industry regulation system and market order, and particularly, policy for preventing monopoly, and system establishment and legislation in market competition rules.

Restructuring of China's petrochemical industry has started. However, tasks in enterprise reform and restructuring from now on are very difficult and hard. We should utilize beneficial international experiences. Positive recommendations for further restructuring of our petrochemical enterprises are welcome.

Thank you.